Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted] TL-N-53-99
[redacted]

date: FEB 16 1999

to: Chief, Examination Division, [redacted]
Attn: [redacted]
Examination Group [redacted]

from: [redacted]
[redacted], Assistant District Counsel
[redacted], Special Litigation Assistant
[redacted], Attorney

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subject: Advisory Opinion Regarding the Deductibility of Advertising Expenses
Taxpayer: [redacted]
Taxable Years Ended September 30, [redacted] September 30, [redacted] and September 30, [redacted]
Our File No. TL-N-53-99

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At your request, we have reviewed the following Notices of Proposed Adjustments: (1) Issue Number 14, adjustments for [redacted] regarding cooperative advertising expenses; (2) Issue Number 16, adjustments for [redacted] regarding cash incentive programs; and (3) Issue Number 25, an adjustment for [redacted] regarding cash incentive programs.

ISSUES

1. Where [redacted] are required to submit claims to receive advertising reimbursements from [redacted] whether [redacted] incurs its liability for advertising reimbursements in the year in which the [redacted] provide the advertising services, rather than in the following year when they submit their claims for reimbursement.

2. For cash incentive programs that are not completed, or do not begin, until the following taxable year, whether [redacted] must wait until the following year to deduct its liability under these programs.

For the reasons set forth below, it is our opinion that:

1. [redacted] may deduct its liability for advertising reimbursements in the year in which the [redacted] provide the advertising services, rather than in the following year in which they submit their claims for reimbursement. Therefore, we recommend you withdraw the Notice of Proposed Adjustment, Issue Number 14.

2. For the cash incentive programs that do not begin until the following taxable year, [redacted] must wait until the following year to deduct its liability under those programs. For the cash incentive programs that begin in the current taxable year, but are not completed until the following taxable year, [redacted] may deduct, in the current year, the cash awards that arise from sales occurring in the current year; [redacted] must wait until the following year to deduct cash awards that arise from sales occurring in the following year.

FACTS

Cooperative Advertising Costs

[redacted] is a [redacted] corporation with its principal office in [redacted]. During the taxable years at issue, [redacted] was the common parent of an affiliated group of corporations which filed consolidated federal income tax returns. At all times relevant to this case, [redacted] was a wholly-owned subsidiary of [redacted] a [redacted] corporation.

[redacted] distributes motor vehicles to regional distributorships, who in turn allocate the motor vehicles to independent [redacted] dealers within the distributorship's region; the dealers then sell the motor vehicles to the public. [redacted] are associations of independent [redacted] dealers within a certain geographic area. [redacted] provides advertising support for [redacted] by reimbursing a portion of their advertising costs through cooperative advertising programs.

To participate in the cooperative advertising programs, [redacted] must sign advertising agreements, which specify:

(1) the period in which the advertising must take place (usually not exceeding two weeks);

(2) the type of advertising required (e.g. television, radio, newspaper, etc.);

(3) the "optimum spending level" of advertising;

(4) the rate of reimbursement, up to a fixed dollar amount;

(5) the deadline for submitting documents substantiating the advertising expenses (i.e. claims for reimbursement)[1]; and

(6) the kinds of substantiating documents that must be submitted.[2]

[redacted]s do not generally file their claims for reimbursement until the year following the performance of the advertising services. [redacted] reviews the claims for accuracy and compliance with the terms of the program, resolving any discrepancies. The claims are then paid.

[redacted] an accrual basis taxpayer, seeks to deduct the advertising reimbursements in the year in which the [redacted]s provide the advertising services, rather than in the following year in which [redacted] submit the claims for reimbursement.

A technical advice memorandum was issued on December 23, 1993, which concluded that [redacted] may deduct the cost of advertising reimbursements in the year in which the claims for reimbursements are submitted. Tech. Adv. Mem. [redacted] ([redacted]). In light of Rev. Rul. 98-39, 1998-33 I.R.B. 4, the question arises whether the prior technical advice represents the current position of the Service.

Cash Incentive Programs

Through various cash incentive programs, [redacted] provides cash awards to dealers and salespersons based on the number of specified car models sold within a certain time period.

[redacted] sends a written explanation of the cash incentive program to the dealers. According to the written explanation, dealers are automatically enrolled in the program, unless they opt-out of the program by signing and returning a non-participation statement on the bottom of the written explanation. The written explanation defines a sale as the "transfer of ownership and/or possession of and title to the motor vehicle directly to the ultimate consumer." An ultimate consumer, in turn, is defined as "one who purchases for use and not for resale." It appears from the written explanation that sales are reported electronically to [redacted]

[redacted] conducts many cash incentive programs in each taxable year, most of them lasting fewer than three or four months.

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[1] [redacted] maintains that it pays claims that are filed late.

[2] The advertising agreements expressly state that reimbursements will be paid "where the expenditure is properly substantiated."

maintains a general reserve account to pay for anticipated expenses; within the reserve account, maintains a separate line item for each cash incentive program. estimates its likely payout under each cash incentive program by assuming that all dealers will participate in the program and by relying on dealers' past sales performances.

deducts its expected payout under each cash incentive program before the program is completed.[3] Examination has not challenged the accrual and deduction of expected payout for those programs that begin and end in the same taxable year. However, it has challenged the deduction of expected payout for programs that are not completed, or do not even officially begin, until the following taxable year.[4]

DISCUSSION

Cooperative Advertising Costs

I.R.C. § 162 allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

The issue here is not whether may deduct the cost of advertising reimbursements as "ordinary" and "necessary" business expense; in fact, advertising expense is mentioned as an example of a generally deductible business expense in Treas. Reg. § 1.162-1(a). The issue here is one of timing–that is, determining the proper taxable year in which may deduct its advertising reimbursement expenses.

Under the accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which: (1) all the events have occurred that establish the fact of the liability; (2) the amount of the liability can be determined with reasonable accuracy;[5] and (3) economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2)(i).

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[3] It appears that deducts the expected payout at one of three possible events: (1) when the cash incentive program is announced; (2) when the line item in the reserve account is created for the cash incentive program; or (3) when the cars targeted by the program are sold to the dealers.

[4] Examples of cash incentive programs which Examination has challenged in taxable year ended September 30, include: (1) Take Stock in Program dates: to ; and (2) Shapin Up 90's (: Program dates: to made no payments under these programs during taxable year ended September 30,

[5] The first two prongs, combined, are known as the "all events" test. I.R.C. § 461(h)(4). This test for liability mirrors the all events test for income under I.R.C. § 451 and Treas. Reg. § 1.451-1(a). Thus, the factors to be considered in determining when a right to income becomes fixed can also be applied in determining when a liability becomes fixed.

a. All Events Establishing the Fact of the Liability

The United States Supreme Court has held that "a liability does not accrue so long as it remains contingent." Brown v. Helvering, 291 U.S. 193, 200 (1934). However, the necessity for mathematical computations or ministerial acts do not preclude the accrual of income or deductions. Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295 (1932). Therefore, the critical determination to be made is whether the submission of claims is necessary to the establishment of taxpayer's liability, or on the other hand, whether the submission of claims is a mere ministerial act. Under the former, the submission of claims is a condition precedent to fixing the liability, and thus, the liability is not established until the year in which the claims are filed. United States v. General Dynamics Corp., 481 U.S. 239, 244 (1987), rev'g 773 F.2d 1224 (Fed. Cir. 1985). In contrast, under the latter, liability is fixed in the year the services are performed, regardless of when the claims are filed. Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295 (1932); Dally v. Commissioner, 227 F.2d 724, 727 (9th Cir. 1955), aff'g 20 T.C. 894 (1953); Rev. Rul. 98-39, 1998-33 I.R.B. 4.

Neither the courts nor the Service has articulated a bright-line test to distinguish between "condition precedent" and a "ministerial act."[6] In Dally v. Commissioner, the Ninth Circuit held that the filing of certified invoices was merely a ministerial act, even though the contract specifically provided for payment upon the submission of properly certified invoices; thus, the Ninth Circuit held that the taxpayer's right to receive the income was fixed in the year the services were provided, not in the year in which the claims were submitted. 227 F.2d at 727; accord Frank's Casing Crew & Rental Tools, Inc. v. Commissioner, 72 T.C.M. (CCH) 611 (1996) (holding that contractor's preparation and sending of invoices were ministerial acts that did not postpone the accrual of income otherwise earned, even though the contract specified that payments were due upon the receipt of the invoices). Along the same logic, the United States Supreme Court held that, even though the federal legislation specified payments to be made upon the submission of claims by taxpayers, an accrual basis taxpayer recognized income in the year in which the statute was enacted. The Court reasoned that the taxpayer's right to the federal payments "ripened" when the legislation became law, and the filing and review of the claims were merely administrative or ministerial acts to ascertain the amounts to be paid. Continental Tie & Lumber Co., 286 U.S. at 295.

An important case holding that the filing of claims was not a ministerial act, but was, in fact, a necessary condition precedent to the fixing of liability, is United States v. General

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[6] Any confusion due to the lack of a bright-line test is compounded by the inconsistent positions that the Service has taken on this issue. For cases where the government has argued that filing a claim is not necessary to fix the right to receive income, see Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932) (supporting government's position) and Franks's Casing Crew & Rental Tools v. Commissioner, 72 T.C.M. (CCH) 611 (1996) (same). For cases where the government has argued the contrary, see Commissioner v. Dumari Textile Co., 142 F.2d 897 (2d. Cir. 1944), Automobile Insurance Co. of Hartford, Connecticut v. Commissioner, 72 F.2d 265 (2d Cir. 1934).

Dynamics Corp. This case involved an accrual basis taxpayer that was a self-insurer of its employee medical plan; it maintained reserve accounts to reflect liabilities for medical care provided to employees who had not yet filed claims for reimbursement as of the end of the taxable year. There, the taxpayer was not permitted to deduct the amount of reserve accounts because the Court determined that the last event necessary to fix the taxpayer's liability was not the receipt of medical care by covered employees, but rather, the filing of properly documented claims. Even though the Court agreed with the lower court's factual finding that the processing of the claims by the taxpayer was "routine," "clerical," and "ministerial in nature," the Court determined that the filing of the claims by the covered employees was not a "mere technicality." 481 U.S. at 244. Because some employees may not file the claims due to "oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received," Id., it concluded that the filing of the claims was not merely ministerial.[7]

In the context of advertising expense, prior to 1998, the Service's position was that if, according to the contract, the reimbursements were contingent on the filing of claims, then the taxpayer may not deduct its liability for the reimbursements until the year in which the claims were filed. The technical advice that was rendered in this case reflected this position. Accord Tech. Adv. Mem. 93-20-001 (Dec. 17, 1992); Tech. Adv. Mem. 93-43-006 (July 13, 1993), rev'g in part, Tech. Adv. Mem. 92-04-003 (Oct. 2, 1991).

In Rev. Rul. 98-39, the Service altered its position. In this revenue ruling, despite the contractual provision requiring the submission of claims to receive the advertising reimbursements, the Service allowed the taxpayer to deduct its liability for the advertising reimbursements in the taxable year prior to the claims having been filed. In reaching this conclusion, the Service determined that the filing of claims was a mere ministerial act--"merely the mechanism by which Y requests payment for advertising services already performed"--and thus distinguishable from General Dynamics Corp. 1998-33 I.R.B. at 5.

As in the revenue ruling, even though [redacted]s advertising agreements require the [redacted] to submit claims to receive the reimbursements, tne filing of the claims is merely a means to receive the reimbursements; it is a mere technicality. Unlike General Dynamics Corp., there is no reason to believe that the [redacted] would refrain from filing the claims. Under these facts, the failure of the dealers to submit properly incurred advertising expenses would be an "extremely remote and speculative possibility."

In conclusion, it is clear from Rev. Rul. 98-39 that the filing of claims is not necessary to establish the fact of [redacted] liability.

b. **Liability Is Established with Reasonable Accuracy**

In addition to the above analysis, a liability is incurred under the accrual method in the

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[7] The Court recognized that the failure of employees to file claims was not an "extremely remote and speculative possibility." Id.

taxable year in which the amount of the liability can be determined with reasonable accuracy. The reasonably accuracy requirement is met when a reasonable estimate of the liability can be made; any discrepancy between the estimate and the actual cost can be adjusted by "an additional assessment or a claim for refund." Continental Tie & Lumber Company, 286 U.S. at 296; Rev. Rul. 98-39, 1998-33 I.R.B. 4.

Generally, as long as there is an agreement on the basis under which the amount due is to be calculated, the reasonable accuracy prong is satisfied. See Frost Lumber Industries, Inc. v. Commissioner, 128 F.2d 693, 694 (5th Cir. 1942) ("Though the computation may be undetermined, if the basis for the computation is unchangeable and though the exact amount may be unknown, if it is not unknowable, the item in such cases is to be treated, for tax purposes, as accrued income."); Food Machinery & Chemical Corp. v. United States, 286 F.2d 177, 184 (Ct. Cl. 1960), cert. denied, 368 U.S. 918 (1961) (reasonable accuracy met where there was a tentative agreement on formula to calculate compensation due for cancellation of government contract).

Here, [redacted] has a reasonable estimate of its liability under the cooperative advertising agreements in the year in which the [redacted]s provide the advertising services. [redacted] knows the number of participants in each cooperative advertising program, since each participant must return a signed agreement to [redacted] moreover, the agreement specifies the "optimum spending level" for the advertising and the maximum amount of the reimbursement. Given such information, [redacted] can reasonably estimate its liability under each cooperative advertising program.

c. Economic Performance Has Occurred with Respect to the Liability

Lastly, I.R.C. § 461(h)(1) states that in determining whether an amount has been incurred with respect to any item during the taxable year, the all events test shall not be treated as met any earlier than the economic performance with respect to such item. If the liability of the taxpayer arises from services to the taxpayer by a third party, economic performance occurs as the third party provides such services. I.R.C. § 461(h)(2)(A)(i).

Here, [redacted] liability stems from advertising services provided by the [redacted]s, and economic performance with respect to [redacted] liability occurs as the [redacted] provide the advertising services.

In conclusion, all three prongs of the test for determining when a liability is incurred are satisfied in the year in which the [redacted]s provide the advertising services; thus, [redacted] may deduct its liability for advertising reimbursement in the year in which the advertising services are provided, regardless of when the claims are filed.

Cash Incentive Programs

Once again, the central issue is one of timing–in what taxable year may [redacted] deduct its estimated payout under the cash incentive programs that are not completed, or do not begin, until the following taxable year?

Under the cash incentive programs, the dealers (or salespersons) earn cash based on their volume of retail sale of specified car models. Thus, the receipt of cash incentives is contingent on the number of retail sales by the dealers. In other words, [redacted] liability for the cash awards ripens as the dealers sell the specified cars. Merely declaring a cash incentive program, or setting aside funds in a reserve account, do not obligate [redacted] to pay the cash awards under these programs.[8]

Moreover, economic performance occurs as the dealers sell the specified cars to the ultimate consumers. The dealers, by participating in the cash incentive programs, provide a service to [redacted] in various forms, such as increasing [redacted] market share, unloading over-stocked cars, etc. As such, economic performance occurs as the dealers sell the specified cars; economic performance does not occur by the mere declaration of a cash incentive program, or by transferring funds to a reserve account.

And finally, as the dealers sell the cars to the ultimate consumers, it is clear that [redacted] knows, with certainty, its liability for the payment of the cash awards, thus more than satisfying the "reasonable accuracy" standard.

In conclusion, [redacted] satisfies the all-events and economic performance tests as the dealers sell the cars to the ultimate consumers. Thus, [redacted] may deduct the amount of cash awards in the same taxable year in which the sale, which is the basis for the cash award, takes place. For example, for programs that do not begin until the following taxable year [redacted] may not deduct its estimated liability for such programs in the current year. Likewise, for programs that begin in the current taxable year and end in the following taxable year, [redacted] may deduct, in the current year, the cash awards which arise from sales occurring in the current year.

CONCLUSIONS AND RECOMMENDATIONS

1. For the reasons set forth above, it is our recommendation that you rescind the Notice of Proposed Adjustment, Issue Number 14, regarding [redacted] liability for cooperative advertising reimbursements.

2. With respect to the various cash incentive programs (Notices of Proposed Adjustments, Issue Numbers 16 and 25), it is our opinion that [redacted] may deduct the amount of cash

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[8] Unlike in the cooperative advertising issue, we do not need to discuss the filing of claims, because it appears that retail sales under the cash incentive programs are electronically filed when the sale takes place.

awards in the same taxable year in which the sale, which is the basis for the cash award, takes place. Thus, for cash incentive programs that do not begin in the current year, [redacted] may not deduct its expected payout under those programs in the current year. Likewise, for those programs that begin in the current taxable year, and in the following taxable year, [redacted] may deduct, in the current year, the cash awards based on sales during the current year.

If you have any questions, please feel free to call [redacted] at [redacted].